IMPROVENET INC
Form 10-Q
November 13, 2001

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

ý	**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2001.**

Or

o	**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from ___________ to _________.**

COMMISSION FILE NUMBER 000-29927

IMPROVENET, INC.

(Exact name of registrant as specified in its charter)

Delaware	**77-0452868**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

1286 Oddstad Drive, Redwood City, CA 94063

(Address of principal executive offices)

(650)-839-8752

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES ý NO o

The number of shares outstanding of the registrant's common stock, $.001 par value, was 17,324,213 as of October 31, 2001.

ImproveNet, Inc.

Form 10-Q

For the Quarter Ended September 30, 2001

Index

PART I - FINANCIAL INFORMATION

ITEM 1 . FINANCIAL STATEMENTS

IMPROVENET, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	SEPTEMBER 30, 2001 (UNAUDITED)	DECEMBER 31, 2000
Assets		
Current assets:		
Cash and cash equivalents	$ 11,974	$ 31,565
Accounts receivable, net	2,453	2,309
Prepaid expenses	989	2,289
Total current assets	15,416	36,163
Property and equipment, net	1,918	4,261
Other assets	996	1,292
Total assets	$ 18,330	$ 41,716
Liabilities & Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,064	$ 2,796
Accrued liabilities	1,945	3,970
Accrual for restructuring	1,137	-
Deferred revenue	142	249
Total current liabilities	5,288	7,015
Long-term liabilities	122	99
Total liabilities	5,410	7,114

Stockholders' equity				
Common stock, $0.001 par value:				
Authorized: 100,000 shares				
Issued and outstanding: 17,324 shares in 2001 and 18,016 shares in 2000		18		18
Treasury stock, 139 shares in 2001, and none in 2000		(56)		-
Additional paid-in capital		145,553		146,334
Unearned stock-based compensation		(7,043)		(11,999)
Accumulated deficit		(125,552)		(99,751)
Total stockholders' equity		12,920		34,602
Total liabilities and stockholders' equity	$	18,330	$	41,716

The accompanying notes are an integral part of these condensed consolidated financial statements.

IMPROVENET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	THREE MONTHS ENDED SEPTEMBER 30,				NINE MONTHS ENDED SEPTEMBER 30,			
	2001 (UNAUDITED)		2000 (UNAUDITED)		2001 (UNAUDITED)		2000 (UNAUDITED)	
Revenues								
Service revenues	$	1,597	$	1,277	$	4,562	$	3,332
Marketing revenues		325		778		1,170		2,034
Total revenues		1,922		2,055		5,732		5,366
Cost of Revenues								
Cost of service revenues (excludes stock-based compensation of $86 and $297 in 2001 and $146 and $503 in 2000)								
		1,283		1,409		3,671		3,725
Cost of marketing revenues (excludes stock- based compensation of $33 and $116 in 2001 and $57 and $214 in 2000)								
		88		107		314		282
Total cost of revenues		1,371		1,516		3,985		4,007
Gross profit		551		539		1,747		1,359
Operating expenses:								
Sales & marketing (excludes stock-based compensation of $1,228 and $3,370 in 2001 and $1,256 and $4,414 in 2000)		3,199		9,759		14,094		32,719

Product development (excludes stock-based compensation of $0 and $0 in 2001 and $6 and $(44) in 2000)		735		1,006		2,731		4,150
General & administrative (excludes stock-based compensation of $12 and $183 in 2001 and $(187) and $652 in 2000)		1,185		2,240		3,811		6,612
Stock-based compensation		1,358		1,278		3,966		5,739
Restructuring charges		1,448		-		3,621		-
Total operating expenses		7,925		14,283		28,223		49,220
Operating loss		(7,374)		(13,744)		(26,476)		(47,861)
Interest income		28		817		675		2,042
Net loss	$	(7,346)	$	(12,927)	$	(25,801)	$	(45,819)
Basic & diluted net loss per share	$	(0.42)	$	(0.79)	$	(1.47)	$	(3.68)
Weighted average shares used in calculating basic and diluted net loss per share		17,294		16,446		17,503		12,467

The accompanying notes are an integral part of these consolidated financial statements.

IMPROVENET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	NINE MONTHS ENDED SEPTEMBER 30,	
	2001 (UNAUDITED)	**2000 (UNAUDITED)**
Cash flows from operating activities:		
Net loss	$ (25,801)	$ (45,819)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,081	907
Loss on disposal of property	5	
Restructuring charges net of cash expenditures		
Reduction in force	294	-
Facilities exit costs	843	-
Asset write-downs	1,588	-
Allowance for doubtful accounts	307	792
Amortization of stock based compensation	3,966	5,907
Warrant charges amortized	253	84
Notes receivable from related party	(120)	-
Net change in operating assets and liabilities:		
Accounts receivable	(451)	(2,549)
Prepaid expenses	1,300	(2,043)
Other assets	239	474
Accounts payable and accrued liabilities	(2,757)	1,781
Deferred revenue	(107)	104
Other long-term liabilities	23	(39)
Net cash used in operating activities	(19,337)	(40,401)
Cash flows from investing activities:		
Purchase of property and equipment	(213)	(3,473)
Restricted cash	(61)	(7)

Issuance of note receivable to related party		-		(1,000)
Net cash used in investing activities		(274)		(4,480)
Cash flows from financing activities:				
Proceeds from issuance of common stock, net of offering costs		-		39,075
Proceeds from exercise of stock options/warrants/ESPP		76		566
Payment for treasury stock purchase		(56)		-
Repayment of stockholder notes receivable		-		5
Net cash provided by financing activities		20		39,646
Net decrease in cash and cash equivalents		(19,591)		(5,235)
Cash and cash equivalents, beginning of period		31,565		45,291
Cash and cash equivalents, end of period	$	11,974	$	40,056

The accompanying notes are an integral part of these condensed consolidated financial statements.

IMPROVENET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Formation and Business of the Company

Nature of the business

ImproveNet, Inc. ("ImproveNet" or the "Company") (formerly Netelligence, Inc.) was incorporated in California in January 1996 and reincorporated in Delaware in September 1998. The Company is a source for home improvement services. The Company generates quality job leads for service providers, including contractors, designers, and architects, from interested homeowners within their geographic area using its proprietary matching service. In addition, the Company provides marketing services on behalf of home improvements suppliers (including manufacturers, distributors, and financial services companies) who wish to advertise their services to the Company s service provider and homeowner audiences. On October 15, 2001 the Company launched its Premiere Services program, which offers the consumer the opportunity to have ImproveNet, Inc. to act as the contractor of record for selected remodeling projects.

Basis of Presentation

The accompanying interim condensed consolidated financial statements as of September 30, 2001 and for the three and nine months ended September 30, 2001 and 2000 are unaudited. The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the annual condensed consolidated financial statements and, in the opinion of management, reflect all adjustments, which are of a normal recurring nature, necessary to present fairly the Company's financial position as of September 30, 2001, results of operations for the three and nine months ended September 30, 2001 and 2000, and cash flows for the nine months ended September 30, 2001 and 2000. The Company's results for an interim period are not necessarily indicative of the results that may be expected for the year.

Although the Company believes that all adjustments necessary for a fair presentation of the interim periods presented are included and that the disclosures are adequate, these condensed consolidated financial statements and notes thereto are unaudited and should be read in conjunction with the audited condensed consolidated financial statements and notes thereto for the year ended December 31, 2000 included in the Company's annual report on Form 10-K filed on April 10, 2001 with the Securities and Exchange Commission derived from audited financial statements. Such disclosures are contained in the Company s annual report on Form 10-K.

The Company has completed several rounds of private equity financing and raised, in its initial public offering, approximately $39.7 million, net of issuance cost, in March 2000. However, the Company has incurred substantial negative cash flows from operations in every fiscal period since inception. For the year ended December 31, 2000, the Company incurred a loss from operations of approximately $57.8 million and negative cash flows from operations of approximately $49.3 million. As of September 30, 2001 the Company had an accumulated deficit of approximately $125.6 million. Management expects operating losses and negative cash flows to continue for the foreseeable future.

The Company expects that losses will decrease from fiscal year 2000 levels due to new sales initiatives and operational cost efficiencies, through decreased marketing expenditures and reduced headcount levels. Operational cost efficiency restructuring has already been initiated - the Company reduced headcount by 7% in July 2000, by 25% in March 2001, and further reduced headcount by another 30% in September 2001. The Company had approximately $12.0 million of cash and cash equivalents at September 30, 2001. Failure to generate sufficient revenues, raise additional capital or reduce operational discretionary spending could have a material adverse effect on the Company's ability to continue as a going concern and to achieve its intended business objectives.

2. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the average number of outstanding shares during the period. Diluted net loss per share is calculated by adjusting the average number of outstanding shares assuming conversion of all potentially dilutive stock options and warrants under the treasury stock method. For all periods presented, potentially dilutive convertible preferred stock, stock options and warrants were excluded from the calculation of diluted net loss per share, as their effect would have been anti-dilutive.

Options to purchase approximately 767,000 shares and warrants to purchase approximately 1.3 million shares were outstanding as of September 30, 2001.

A reconciliation of the numerator and denominator used in the calculation of the basic and diluted net loss per share follows: (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	**2000**	**2001**	**2000**
Numerator				
Net loss attributable to stockholders	$ (7,346)	$ (12,927)	$ (25,801)	$ (45,819)
Denominator				
Weighted average shares	17,427	16,809	17,892	12,961
Weighted average shares subject to repurchase	(133)	(363)	(389)	(494)
Denominator for basic and diluted calculation	17,294	16,446	17,503	12,467
Basic and diluted net loss per share	$ (0.42)	$ (0.79)	$ (1.47)	$ (3.68)

3. Multi-Year Commercial Contracts

The Company has entered into multi-year commercial marketing contracts, some of which are with related parties. These commercial contracts generally provide marketing services that include a mix of banners and button advertising, SmartLeads and other marketing services, including FIND-A-CONTRACTOR or POWERED BY IMPROVENET, plus a continuous presence, on the Company's Web sites for a fixed annual fee. These commercial contracts are for periods ranging between 2 and 12 years, including renewal options. These commercial contracts also include cooperative marketing arrangements under which the Company is obligated to spend 50% to 100% of the fees the Company expects to receive. Cooperative marketing expenditures are incurred on behalf of these commercial parties for principally television and print media. In return, the Company expects to receive significant marketing benefits including better advertising rates, stronger brand recognition, and access to customer databases, direct mail inserts and marketing resources - all designed to generate more traffic to the Company s sites and jobs to its proprietary matching services.

As the Company does not have an established historical practice of selling advertising for cash for similar multi-year commercial contracts, the Company has not assigned any value to the exchange of services or barter element of these transactions and accordingly, the Company has not recorded either revenue or sales and marketing expense for the barter element. However, some of these multi-year commercial contracts do generate an overall net cash component to the Company, and in these cases, the Company has recorded revenue based on the cash received or receivable under the contract, net of the obligation, if any, to reimburse the commercial party for the cooperative marketing and other marketing services. These revenues are recognized over the term of the commercial contract once marketing and other services have been delivered to the commercial party and collection of the resulting net receivable is deemed probable.

Furthermore, in connection with certain of these multi-year commercial contracts, the Company also issued warrants to purchase shares of the Company's common stock to the commercial parties. These warrants have been valued by the Company using the Black Scholes option pricing model. As the fair value of these warrants represent an additional rebate on the revenue otherwise recorded under the contracts, the amortization of the warrants is further netted against this revenue over the term of the respective commercial contract. To the extent that there are insufficient revenues, the remaining amortization of warrant stock-based compensation is expensed and characterized as sales and marketing expense.

4. Segment Information

The Company currently operates in a single business segment, as there is only one measurement of profitability for its operations. Through September 30, 2001, foreign operations have not been significant in either revenues or investments in long-lived assets.

A summary of the Company s revenues by service offerings is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	**2000**	**2001**	**2000**
Service revenues:				
Lead fees	$ 298	$ 421	$ 1,109	$ 1,066
Win fees	1,245	792	3,223	2,132
Other fees	54	64	231	133
Total service revenues	1,597	1,277	4,563	3,332
Marketing revenue	325	778	1,170	2,034
Total revenues	$ 1,922	$ 2,055	$ 5,733	$ 5,366

For the nine month period ended September 30, 2001 one customer represented approximately 12% of total revenues. No other customers represented over 10% of total revenues.

5. Comprehensive Loss

The Company follows SFAS No. 130, "Reporting Comprehensive Income" ("SFAS No. 130"). SFAS No. 130 establishes standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. There was no difference between the Company's net loss and its comprehensive loss for any of the periods presented in the accompanying condensed consolidated statements of operations.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS 141 requires the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Use of the pooling-of-interests method is prohibited. SFAS141 also provides new criteria to determine whether an acquired intangible asset should be recognized separately from goodwill.

Upon adoption of SFAS 142, amortization of existing goodwill would cease and the remaining book value would be tested for impairment at least annually at the reporting unit level using a new two-step impairment test. Amortization of goodwill recorded on equity investments would also cease, but this embedded goodwill will continue to be tested for impairment under current accounting rules for equity investments. In addition, we will have adjustments to the equity in net income of affiliates line item to reflect the impact of adopting these new statements on the operations of our equity investments. We will adopt both statements on January 1, 2002 and are currently evaluating the impact of these statements.

We have not yet quantified the impact of these statements on the operations of our equity investments. Annual pre-tax amortization expense of our existing and embedded goodwill for 2001 will be approximately $133,000. During 2002, we will perform the first of the required impairment tests of goodwill as of January 1,2002, and we have not yet determined what the effect of these tests will be on our earnings and financial position. Any impairment resulting from our initial application of the statements will be recorded as a cumulative effect of accounting change as of January 1, 2002.

6. Related Party Transactions

Notes Receivable from Officer

In May 1999, the Company entered into an employment related promissory note agreement with its Chairman and Chief Executive Officer, Ronald B. Cooper, whereby the Company agreed to loan the officer up to $500,000. The full amount was loaned in August 1999. The note accrues interest at 5.25% per annum and is due and payable on the earlier of April 1, 2002 or within 90 days after the voluntary termination of the officer's employment or the termination of the officer's employment for cause. The note is collateralized by the officer's shares of stock and options to purchase shares of stock. In April 2000, the Company loaned its Chairman and Chief Executive Officer $1.0 million accruing interest at a rate of 6.46% per annum and repayable on the earlier of April 30, 2002 or when the borrower is able to collateralize or borrow on margin using his Company stock. Both loans are collateralized by the stock owned by the borrower. In accordance with FAS 114 Accounting by Creditors for Impairment of a Loan", these notes receivable were valued at the market value of the stock held as collateral.

In July 2001, the Board of Directors determined that it was in the best interests of the Company to settle the two non-recourse loans in order to retain Ronald B. Cooper as President and CEO. The additional write down of the two non-recourse notes was approximately $178,000 on September 30, 2001 to reflect the fair market value during the period. In July 2001, ImproveNet, Inc. repurchased all outstanding stock, which had been collateralized against the notes, totaling 400,000 shares with a fair market value of approximately $120,000. Ronald B. Cooper remains a less than 5% shareholder in ImproveNet, Inc.

7. Restructuring Accrual

In March 2001 the Company announced a restructuring plan to reduce costs and improve productivity which resulted in a restructuring charge in the first quarter of 2001 of $1,992,000 and $181,000 in the second quarter. In September 2001, the Company announced an additional restructuring plan in an effort to reduce costs, which totaled $1,448,000 and included the additional termination of employees and the closure of its Camarillo facilities located in Southern California.

Of the total restructuring charge of approximately $3.6 million, $629,000 relates to employee termination benefits related to the first quarter restructuring and $209,000 relates to employee termination benefits for the third quarter restructuring, for a total workforce restructuring charge of $838,000. The company terminated approximately 55 employees as of April 1, 2001 and 46 additional employees in September 2001. At the end of the third quarter $545,000 of the termination benefits had been paid. This resulted in a remaining liability of $293,000 at September 30, 2001 which is expected to be fully utilized by the first quarter of 2002.

The Company has downsized its facilities in Northern California in order to increase efficiencies. The restructuring charge of $593,000 in the first quarter and $181,000 in the second quarter relate to facility exit costs and the calculation is based on current market conditions with this amount being reviewed by management on a quarterly basis. An additional $421,000 of restructuring charges for both the Camarillo and the Northern California facilities was recorded in the third quarter. After subtracting rental payments made during the quarter of $167,000 in the second quarter and $184,000 in the third quarter the balance at the end of the third quarter is $844,000.

Under the restructuring plan the company took a charge of $770,000 and $818,000 net of salvage value, in the first and third quarters, respectively, for the write-down of assets included in property, plant and equipment. These assets primarily included office furniture and equipment.

The restructuring charges were determined based on formal plans approved by the Company's management using the best information available to it at the time. The amounts the Company may ultimately incur may change as the restructuring initiative is executed.

The activity impacting the accrual for restructuring charges during 2001 are summarized in the table below:

(In thousands)	Facilities	Workforce reductions	Asset write-downs	Total
Balance at December 31, 2000	$ -	$ -	$ -	$ -
Charges to operations in three months ended March 31, 2001	593	629	770	1,992
Charges utilized in three months ended March 31, 2001	-	-	-	-
Balance at March 31, 2001	593	629	770	1,992
Charges to operations in three months ended June 30, 2001	181	-	-	181
Charges utilized in three months ended June 30, 2001	(167)	(411)	(770)	(1,348)
Balance at June 30, 2001	607	218	-	825
Charges to operations in three months ended September 30, 2001	421	209	818	1,448
Charges utilized in three months ended September 30, 2001	(184)	(134)	(818)	(1,136)
Balance at September 30, 2001	844	293	-	1,137

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read with our condensed consolidated financial statements and notes included elsewhere in this Report on Form 10-Q. The discussion in this Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. The cautionary statements made in this Report on Form 10-Q should be read as applying to all related forward-looking statements wherever they appear in this Report on Form 10-Q. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to these differences include those discussed in "Business Risks" below as well as those discussed elsewhere.

OVERVIEW

Our business started in January 1996 as a regional contractor matching service, and we spent most of 1996 and 1997 building our service provider database, developing new services and technology, recruiting personnel and raising capital. We launched our Web site and homeowner/service provider matching service on a national scale in August 1997. In December 1998, we began selling Web site advertising, including SmartLeads services, a way for suppliers of home improvement products to send targeted messages about their products, including product promotions, to homeowners at the time of purchase, as well as to our network of service providers. In March 1999, we began to hire our new senior management team, including our chief executive officer. In April 1999, we introduced Powered by ImproveNet, a service that allows third parties to offer the ImproveNet matching services and content on their Web sites, for national suppliers of home improvement and repair products. We completed the acquisition of two regional contractor referral companies, Contractor Referral Service, LLC and The J.L. Price Corporation, in September and November 1999, these entities were integrated into our operations during the course of calendar year 2000. In March 2000, we completed our IPO. From January through June 2000 we spent substantial amounts primarily on marketing and other marketing related activities, as well as the development and expansion of our service and operations infrastructure. In July 2000 we had a reduction in force, reducing our staff by approximately 7%. Additionally, in March 2001 we restructured our operations, resulting in a staff reduction of 25% and we closed our largest facility in Redwood City, California. A further reduction in staff of 29% and the closure of our Camarillo, California facility occurred in September 2001. We estimate that the cumulative effect of our restructuring activities, in combination with other operating efficiencies, will reduce pro forma annualized operating expenses by more than 35 percent to approximately $19 million in calendar year 2002 versus approximately $30 million in calendar year 2001 and $60 million in calendar year 2000.

We currently generate the majority of our revenues from service provider referral services, installed sales services, marketing packages and advertisements placed on our Web site. We generate service revenues primarily in the form of lead fees and win fees from our service providers and, to a much lesser extent, other fees for the enrollment of service providers. We generate installed sales revenue from the fees that we charge home improvement suppliers (primarily Home Depot) to provide labor services when they sell products on an installed basis. We generate marketing revenues from the sale of banner, button and other advertising on our Web sites, and from the sale to suppliers of SmartLeads generated from the traffic of homeowners visiting our Web sites and from the sale of Find-A-Contractor or Powered by ImproveNet products in commercial agreements. Our marketing revenues generally come from suppliers of home improvement products.

As part of the restructuring initiatives occurring in September 2001 ImproveNet s field sales team and inside support organization will focus primarily on Premiere Services, which includes Installed Sales for home improvement retailers and Managed Repair of insurance and warranty claims, as well as upcoming new homeowner offerings with extensive project support.

RESULTS OF OPERATIONS

REVENUES

Our revenues decreased to approximately $1.9 million for the three months ended September 30, 2001 from approximately $2.1 million for the three months ended September 30, 2000, a decrease of $133,000 or 6%. For the nine months ended September 30, 2001, revenues increased to approximately $5.7 million as compared to approximately $5.4 million for the nine months ended September 30, 2000, an increase of $366,000 or 7%.

The decline in revenues for the 3rd quarter 2001 is primarily due to the overall decline in the market for advertising services.

The following table and discussion highlights our revenues for the three and nine months ended September 30, 2001 and 2000 (in thousands):

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2001	**2000**	**% Change**	**2001**	**2000**	**% Change**
Revenues:						
Service revenue	$ 1,597	$ 1,277	25 %	$ 4,562	$ 3,332	37 %
Marketing revenue	325	778	-58 %	1,170	2,034	-42 %
Total revenues	$ 1,922	$ 2,055	-6 %	$ 5,732	$ 5,366	7 %

Service Revenues

Service revenues increased to approximately $1.6 million for the three months ended September 30, 2001 from approximately $1.3 million for the three months ended September 30, 2000, an increase of $320,000 or 25%. For the nine months ended September 30, 2001, revenues increased to approximately $4.6 million as compared to approximately $3.3 million for the nine months ended September 30, 2000, an increase of approximately $1.2 million or 37%. The increase in revenues was attributable to a combination of changes to the Company s fee structure, and growth in the installed sales revenue.

Service revenues consists of lead fees that our service providers pay to bid a job, win fees that they pay if they are awarded the job, and enrollment fees that they pay to participate in our network. The following table details the components of service revenues, based on a percentage of service revenues:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001 %	**2000 %**	**2001 %**	**2000 %**
Lead Fees	19	33	24	32

Win Fees	78	62	71	64
Other Fees	3	5	5	4
Total Service Revenue	100	100	100	100

Lead fee revenues are recognized at the time the service providers and the homeowner are first matched, while win fee revenues are recognized at the time the service provider or the homeowner notifies us that a job has been sold. For both lead fees and win fees, the recognition of revenues coincides with the service providers' obligation to pay us. Installed sales revenues, which are included in lead fees and win fees are recognized when the service is delivered on behalf of Home Depot, evidence of approval is in place, the project is complete, and the fees are fixed and determinable and collectible. Revenues from new service provider enrollment fees are recognized as revenue ratably over the expected period they participate in our contractor matching service, which is initially estimated to be one year.

The revenues we generate from lead and win fees are largely a function of:

the number of job submissions;

the effectiveness in finding a service provider or match for each job submission;

the success of the service provider to win a job; and

the amount we charge the service provider for a lead or a win.

The following table provides information on some of our key business metrics (numbers in thousands):

Key Metrics	**Three Months Ended September 30,**		**Nine Months Ended September 30,**	
	2001	**2000**	**2001**	**2000**
Job submissions	28.7	41.7	98.6	106.0
Matched jobs	16.6	31.6	62.3	76.0
Won jobs	2.4	3.2	8.4	8.4
Matched jobs as a % of job submissions	57.8 %	76 %	63.2 %	72 %
Won jobs as a % of job submissions	8.4 %	7.7 %	8.5 %	8 %

The decline in job submissions was due primarily to softer economic conditions and the impact of recent world events upon the repair and remodeling industry. The decrease in matched jobs as a percentage of job submissions reflected reduced availability of our key service providers along with an increased focus on bidding jobs that have higher win rates. The increase in won jobs as a percentage of job submissions also reflects the focus on bidding jobs with higher win rates as well as the effect of pricing changes. Specifically, in calendar year 2000, and for calendar year 2001 through March 31, 2001, the win fees that we charged to our service providers depended on project size and ranged from 2% to 10% of the estimated cost of the job, up to a maximum of $995 per job. Effective March 22, 2001, the win fees we charged our service providers depended on project size and ranged from 1% to 10% of the estimated cost of the job, without a maximum per job. As of October 15, 2001, additional pricing changes were announced wherein service providers pay an individual lead fee based on the budgeted dollar value of the job. This lead fee ranges from $10 to $100. Additionally our service providers pay a fee of 1% (based on actual contract value) for all jobs they win. The win fee is waived for all jobs with an actual contract value less than $2,500.

Marketing Revenues

Marketing revenues decreased to $325,000 for the three months ended September 30, 2001 from $778,000 for the three months ended September 30, 2000, a decrease of $453,000 or 58%. For the nine months ended September 30, 2001, revenues decreased to approximately $1.2

million as compared to approximately $2.0 million for the nine months ended September 30, 2000, a decrease of $864,000 or 43%.

We generate marketing revenues from the sale of banner, button and other advertising on our Web sites, and from the sale to suppliers of SmartLeads generated from the traffic of homeowners visiting our Web sites and from the sale of Find-A-Contractor or Powered by ImproveNet products in commercial agreement products and services. In the 2nd quarter of 2001, we launched our Pro Partners Contractor and marketing program, in which we provide sales and marketing services to our network of service providers for which we are paid a fee based upon their purchases. Our marketing revenues generally come from suppliers of home improvement products.

We anticipate that advertising revenues will continue to decline during 2001 as internet advertising spending slows and advertisers demand better monetary terms for the same number of impressions or more impressions for the same dollar amounts. Revenues from the Pro Partners contract and marketing program have not provided significant additional revenue during the remainder of 2001 but are expected to grow in 2002.

Cash Advertising

Cash advertising revenues generally are derived from short-term advertising contracts in which we typically guarantee that a minimum number of impressions will be delivered to our Web site visitors over a specified period of time for a fixed fee. Cash advertising revenues from banner, button and other Web site advertisements are recognized at the lesser of the amount recorded ratably over the period in which the advertising is delivered or the percentage of guaranteed impressions delivered.

SmartLeads are also paid for in cash and revenues are recognized when the SmartLeads have been delivered to the customer. Cash advertising is recognized when we have delivered the advertising, evidence of an agreement is in place and fees are fixed, determinable and collectible. Cash advertising decreased to $14,000 for the three months ended September 30, 2001 from $256,000 for the three months ended September 30, 2000, a decrease of $242,000 or 95%. For the nine months ended September 30, 2001, cash advertising decreased to $103,000 as compared to $673,000 for the nine months ended September 30, 2000, a decrease of $570,000 or 85%. This decline is reflective of the slowdown in advertising spending, particularly on the Internet.

Multi-year Commercial Contracts

Commencing September 1999, we entered into multi-year commercial contracts, some of which are with related parties. These commercial contracts generally provide for a fixed annual fee, an advertising or branding package that includes a mix of buttons, banners, SmartLeads and other marketing or branding services, including Find-A-Contractor or Powered by ImproveNet, plus a continuous presence, on our Web sites. These commercial contracts are for periods ranging between 2 and 12 years, including renewal options. These commercial contracts also include cooperative marketing arrangements under which we are obligated to fund cooperative branding expenditures on television and in the print media, with or on behalf of the commercial party. Most commercial contracts provide for us to spend 50% to 100% of the fees that we expect to receive. In return, we expect to receive significant marketing and branding benefits including better advertising rates, stronger brand recognition, and access to customer databases, direct mail inserts and marketing resources - all designed to generate more traffic to sites and jobs to proprietary matching services.

We do not have an established historical practice of selling advertising for cash for similar multi-year commercial contracts, we have not assigned any value to the exchange of services or barter element of these transactions and accordingly, we have not recorded either revenue or sales and branding expense for the barter element. However, some of these multi-year commercial contracts do generate an overall net cash component, and in these cases we have recorded revenue based on the cash received or receivable under the contract, net of the obligation, if any, to reimburse the commercial party for the cooperative branding and other marketing services. These revenues are recognized over the term of the commercial contract once advertising and other services have been delivered to the commercial party and collection of the resulting net receivable is deemed probable. Revenue from multi-year commercial contracts, net of warrant charges, totaled $306,000 for the three months ended September 30, 2001, and $449,000 for the three months ended September 30, 2000. For the nine months ended September 30, 2001 and 2000, revenue from multi-year commercial contracts, net of warrant charges, totaled approximately $1.1 million and for the nine months ended September 30, 2000 revenue totaled $670,000.

Furthermore, in connection with certain of these multi-year commercial contracts, we issued warrants to purchase shares of our common stock to the commercial parties. These warrants have been valued by us using the Black Scholes option pricing model. As the fair value of these warrants represent an additional rebate on the revenue otherwise recorded under the contracts, the amortization of the warrants is further netted against this revenue over the term of the respective commercial contract. To the extent that there are insufficient revenues, the remaining amortization of warrant stock-based compensation is expensed and characterized as sales and branding expense.

Total revenues may be analyzed as follows (in thousands):

		Three Months Ended September 30, 2001	Three Months Ended September 30, 2000	Nine Months Ended September 30, 2001	Nine Months Ended September 30, 2000
Service revenues		$ 1,597	$ 1,277	$ 4,562	$ 3,332
Marketing revenues		680	1,490	2,402	4,165
Less:	Amounts invoiced and accrued under multi-year commercial contracts with related parties	(271)	(628)	(979)	(1,879)
Less:	Amortization of warrant stock-based compensation	(84)	(84)	(253)	(252)
Total marketing revenues		325	778	1,170	2,034
Total revenues		$ 1,922	$ 2,055	$ 5,732	$ 5,366

OPERATING EXPENSES

Cost of Revenues

Our total cost of revenues decreased to approximately $1.4 million for the three months ended September 30, 2001 from approximately $1.5 million for the three months ended September 30, 2000, a decrease of $145,000 or 10%. For the nine months ended September 30, 2001, cost of revenues remained approximately the same at approximately $4.0 million as compared to the nine months ended September 30, 2000.

Our cost of service revenues decreased to approximately $1.3 million for the three months ended September 30, 2001 from approximately $1.4 million for the three months ended September 30, 2000, a decrease of $126,000 or 9%. For the nine months ended September 30, 2001, cost of service revenues remained approximately the same at $3.7 million as compared to the nine months ended September 30, 2000.

Our cost of marketing revenues decreased to $88,000 for the three months ended September 30, 2001 from $107,000 for the three months ended September 30, 2000, a decrease of $19,000 or 18%. For the nine months ended September 30, 2001, cost of marketing revenues increased to $314,000 as compared to $282,000 for the nine months ended September 30, 2000, an increase of $32,000 or 11%.

Total cost of revenues consists of payroll and related costs and occupancy, telecommunications and other administrative costs for our project services group, which is responsible for all phases of our proprietary matching services and includes our project advisors. In addition, cost of revenues includes an allocation of direct Web site operations costs, consisting of payroll and related costs, data transmission costs and equipment depreciation. It also includes subcontractor labor costs for our Installed Sales Services.

The decrease in the cost of service revenues is a result of the restructuring in the first quarter of 2001, which reduced payroll and related costs, facilities and related costs, as well as the leveraging of our infrastructure against increased revenues somewhat offset by higher subcontractor labor costs. We anticipate that our cost of service revenues will remain constant or decline during the remainder of 2001.

Sales and Marketing

Our sales and marketing expense decreased to approximately $3.2 million for the three months ended September 30, 2001 from approximately $9.8 million for the three months ended September 30, 2000, a decrease of approximately $6.6 million or 67%. For the nine months ended September 30, 2001, sales and marketing expense decreased to approximately $14.1 million as compared to approximately $32.7 million for the nine months ended September 30, 2000, a decrease of approximately $18.6 million or 57%.

Our sales and marketing expense includes all of our online and offline direct marketing and advertising, public relations and trade show expenses. Sales and marketing expenses also include payroll and related costs, travel costs and other general expenses of our marketing, professional services and partnership services departments.

The decrease in sales and marketing expenses was primarily attributable to

Renegotiating or transitioning new or existing agreements from a high fixed cost formula to a variable performance - based formula keyed to won jobs.

Reduced online and offline brand advertising spending, and

Reduced staffing-related expenses as a result of our restructuring during the first quarter.

We fully anticipate that these expenses will continue to decline during 2001, as compared to year 2000 as we plan to leverage our existing infrastructure and to continue the process of negotiating or transitioning agreements from a high fixed cost formula to a variable performance-based formula keyed to won jobs.

Product Development

Our product development expenses decreased to $735,000 for the three months ended September 30, 2001 from approximately $1.0 million for the three months ended September 30, 2000, a decrease of $271,000 or 27%. For the nine months ended September 30, 2001, product development expenses decreased to approximately $2.7 million as compared to $4.2 million for the nine months ended September 30, 2000, a decrease of approximately $1.5 million or 36%.

Our product development costs include the payroll and related costs of our editorial and technology staff, fees for contract content providers, other costs of Web site design and new technologies required to enhance the performance of our Web sites.

The decrease in product development expenses were primarily attributable to decreased payroll and related costs and decreased usage of contract content providers. We expect product development costs to remain at these levels for the foreseeable future.

General and Administrative

Our general and administrative expenses decreased to approximately $1.2 million for the three months ended September 30, 2001 from approximately $2.2 million for the three months ended September 30, 2000, a decrease of approximately $1.0 million or 45%. For the nine months ended September 30, 2001, general and administrative expenses decreased to approximately $3.8 million as compared to approximately $6.6 million for the nine months ended September 30, 2000, a decrease of approximately $2.8 million or 42%. The decrease in general and administrative expense is a result of restructurings.

Our general and administrative expenses include payroll and related costs and travel, recruiting, professional and advisory services and other general expenses for our executive, finance and human resource departments. We expect General and Administrative costs to remain at these levels for the foreseeable future.

Restructuring Charges

During the nine months ended September 30, 2001 the Company has announced two major restructuring initiatives to improve operating efficiencies and support new revenue growth initiatives to drive profitability. The first was in March 2001 and the second in September 2001.

This resulted in a charge of $629,000 of reduction in workforce costs, $593,000 of facility costs and $770,000 related to asset write-downs incurred in the first quarter of 2001.

During the second quarter, $578,000 of costs was charged against the restructuring accrual of which $411,000 related to employee termination costs and the remainder to exit facility costs. An additional $181,000 restructuring charge was incurred in the quarter, which related to facility costs in Northern California. Due to the current volatility of the office leasing industry, management is reviewing these costs on a quarterly basis.

ImproveNet announced an additional restructuring plan in the third quarter of 2001, in an effort to further improve operating efficiencies which resulted in the charge of $209,000 for reduction in workforce costs, $421,000 of facility costs and $818,000 related to asset write-downs.

During the third quarter, a total of $1,136,000 of costs was charged against the restructuring accrual of which $184,000 related to facility exit costs, $134,000 related to employee termination benefits and the remainder to asset write-downs.

Stock-based Compensation

Our stock-based compensation expenses increased to approximately $1.4 million for the three months ended September 30, 2001 from approximately $1.3 million for the three months ended September 30, 2000, an increase of $100,000 or 6%. For the nine months ended September 30, 2001, stock based compensation expenses decreased to approximately $4.0 million as compared to approximately $5.7 million for the nine months ended September 30, 2000, a decrease of approximately $1.7 million or 30%. The decrease is due to the reductions in workforce.

In connection with certain employee and non-employee stock option grants during 1998 and 1999, we recorded unearned stock-based compensation totaling approximately $13.8 million, which is being amortized over the vesting periods of the related options, generally four years using the method set out in FASB Interpretation No. 28, or "FIN 28". Under the FIN 28 method, each vested tranche of options is accounted for as a separate option grant awarded for past services. Accordingly, the compensation expense is recognized over the period during which the services have been provided. This method results in higher compensation expense in the earlier vesting periods of the related options. Stock based compensation charges associated with employees who terminate their employment with us and have unvested options are reversed.

Interest Income

Our interest income decreased to $28,000 for the three months ended September 30, 2001 from $817,000 for the three months ended September 30, 2000, a decrease of $789,000 or 97%. For the nine months ended September 30, 2001, interest income decreased to $675,000 as compared to approximately $2.0 million for the nine months ended September 30, 2000, a decrease of approximately $1.3 million or 66%.

The decrease in interest income is attributable to a decrease in our average invested cash balances. We expect a decline in our interest income during the remainder of 2001 due to the expected decline in our cash and cash

equivalents balances during the year 2001.

Income Taxes

We have recorded a 100% valuation allowance against our net deferred tax assets, which arose primarily as a result of our aggregate operating losses. The valuation allowance will remain at this level until such time as we believe that the realization of the net deferred tax assets is more likely than not. Accordingly, our results of operations do not reflect any tax benefits for our reported losses.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents totaled approximately $12.0 million at September 30, 2001 a decrease of approximately $19.6 million or 62% from approximately $31.6 million at December 31, 2000. The decrease primarily came from the approximately $23.5 million cash used in operating activities which largely reflected our net loss for the period.

Since our inception, we have primarily financed our operations through private sales of our convertible preferred stock and common stock. In March 2000, we closed our initial public offering that generated net cash proceeds of approximately $39.7 million. Our primary capital needs have been to fund our operating losses; the prepayment of our large media purchases and to make capital expenditures.

Net cash used in operating activities was approximately $19.3 million in the nine months ended September 30, 2001, a decrease of approximately $21.1 million from approximately $40.4 million for the nine months ended September 30, 2000, primarily due to a decrease in our net loss after adding back noncash stock-based compensation, other charges, an overall decrease in accounts receivable, and prepaid expenses, partially offset by a decrease in accounts payable and accrued liabilities.

A result of our restructurings, there has been a significant decrease in the payroll expense and associated cash paid in comparison to the first nine months of 2000 as a result of the decrease in average headcount in the period from 276 in 2000 to 121 in 2001. In addition, in the third quarter of 2001 additional resources have been focused on cash collections procedures in order to improve our working capital management.

Net cash used in investing activities was $274,000, a decrease of approximately $4.1 million from approximately $4.5 million in the periods ended September 30, 2001 and 2000, respectively, due to the focus of the business in restructuring operations in 2001, and necessary decreases in capital expenditures. Net cash used in investing activities was a result of purchase of property and equipment related to upgrading the leased facilities at our Oddstad Drive location in Redwood City.

Net cash provided by financing activities has decreased by approximately $39.6 million from approximately $39.6 million to $20,000 in the nine month periods ended September 30, 2000 and 2001, respectively, due to the issuance of common stock in connection with our initial public offering in the period ended March 31, 2000.

Our capital requirements depend on numerous factors, including the success of our strategies for generating revenues and the amount of resources we devote to operating activities, including sales, marketing and brand promotion and investments in our technology. Our expenditures have substantially increased since inception as our operations and staff have grown. Based on the realignment of our resources, we expect a decrease in most of our operating expenses categories detailed above for 2001 as compared to 2000. Additionally, we expect our capital expenditures for 2001 to decrease significantly. We expect to experience ongoing operating losses for the foreseeable future. We currently anticipate that our operating expenses, primarily sales and marketing expenditures, and payroll and related costs will constitute a significant use of our current cash resources.

Our limited operating history and operating losses have limited our ability to obtain vendor credit or extended payment terms and bank financing on favorable terms; accordingly, we depend on our cash and cash equivalent balances to fund our operations.

We currently believe that our available cash resources will be sufficient to meet our anticipated needs for operations and capital expenditures for the next 12 months. We will strive to make ongoing realignments, as required, to achieve positive cash flow with our existing cash resources. We restructured our operations and we have reduced our headcount during the year ended December 31, 2000 and also in the first and third quarters of 2001. We are additionally decreasing our marketing expenditures to assist us in maintaining our available cash resources. We may need to raise additional funds, however, in order to fund more rapid expansion, to develop new or enhance existing services, to respond to competitive pressures or to acquire complementary businesses, services or technologies. If we raise additional funds by selling equity securities, the percentage ownership of our stockholders will be reduced. We cannot be sure that additional financing will be available on terms favorable to us, or at all. If adequate funds are not available on acceptable terms, our ability to fund expansion, react to competitive pressures, or take advantage of unanticipated opportunities would be substantially limited. If this occurred, our business would be significantly harmed. We will continue to evaluate our needs for funds based on our assessment of access to public or private capital markets and the timing of our need for funds. Although we have no present intention to conduct additional public equity offerings, we may seek to raise these additional funds through private or public debt or equity financings.

RISK FACTORS THAY MAY AFFECT OUR RESULTS OF OPERATIONS AND FINANCIAL CONDITION

This document contains certain forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "anticipates', "believes", "continue", "could", "estimates", "expects", "intends", "plans", "potential", "predicts", "should" or "will" or the negative of these terms or other comparable terminology which are intended to identify certain of these forward-looking statements. The cautionary statements made in this document should be read as being applicable to all related forward-looking statements wherever they appear in this document. The Company's actual results could differ materially from those discussed in this document. Factors that could cause or contribute to such differences include those discussed below, as well as those discussed in the Company's Annual Report on Form 10-K.

We have large accumulated losses, we expect future losses, and we may not achieve or maintain profitability.

We have incurred substantial losses and used substantial cash to support our operations as we have expanded our sales and marketing programs, funded the development of our services, promoted our Web sites and matching service and expanded our operations infrastructure. As of September 30, 2001, our accumulated loss was approximately $125.6 million. We expect our expenditures on sales and marketing activities, support field services and the development of new products, services and technologies to continue at a reduced rate, as we restructured our business in March 2001 and in September 2001. We will continue to lose money unless we significantly increase our revenues. We cannot predict when, if ever, we will operate profitably.

We are an early stage company and we have recently restructured our business to offer new services. As a result, we have a limited history, which makes it difficult to evaluate our business.

We were incorporated in January 1996; however, we did not begin offering home improvement services on the Internet until August 1997. In December 1998, we began selling Web site advertising. Until March 1999, we focused primarily on building our network of service providers and refining our matching services processes. In March 1999, we hired our Chief Executive Officer and commenced recruiting our senior management. In April 1999, we introduced Powered by ImproveNet, a service that allows third parties to offer the ImproveNet matching services and content on their Web sites, for national suppliers of home improvement and repair products. In November 1999, we launched our customized Web site for service providers. We completed the acquisition of two regional contractor referral companies, Contractor Referral Service, LLC and The J.L. Price Corporation, in September and November 1999. We experienced reductions in force in July 2000. In the second half of 2000 we significantly reduced our marketing expenditures. In the first and third quarters of 2001, we implemented cost restructuring initiatives that included a reduction in force of approximately 106 people. Furthermore, even if our business is successful, we may change our business to enter into new business areas such as our Premeire Services offerings which are in the process of launching into selected geographic regions. These and other new business initiatives are areas in which we do not have extensive experience.

Because we are no longer listed on the Nasdaq National Market, the liquidity of our common stock may be seriously limited.

On June 29, 2001, we received a Nasdaq Qualification Panel Decision indicating that we have failed to comply with the minimum bid price requirement for continued listing, and were delisted from the Nasdaq National Market. Our stock is currently being traded on the Nasdaq over-the-counter bulletin board, however, we believe that our liquidity will be significantly lower than when it was on the Nasdaq National Market.

Failure to raise additional capital or generate the significant capital necessary to expand our operations and invest in new products and services could reduce our ability to compete and result in lower revenues.

If we are unable to generate sufficient cash flows from operations to meet our anticipated needs for working capital and capital expenditures, we will need to raise additional funds to fund brand promotions, develop new or enhanced services or respond to competitive pressures. We cannot be certain that we will be able to obtain additional financing on favorable terms, or at all. If we need additional capital and cannot raise it on acceptable terms, we may not be able, among other things, to:

- develop or enhance our services;
- develop or acquire new technologies, products or businesses;
- expand operations in the United States or internationally;
- hire, train and retain employees; or
- respond to competitive pressures or unanticipated capital requirements.

Our failure to do any of these things could result in lower revenues and could harm our business or cause us to discontinue operations.

In addition, we may seek to raise additional funds, finance acquisitions or develop commercial relationships by issuing equity or convertible debt securities, which would reduce the percentage ownership of existing stockholders. Furthermore, any new securities could have rights, preferences or privileges senior to those of our common stock.

Our financial results will be affected by seasonality and cyclical fluctuations in the home improvement industry.

Our limited operating history and rapid growth make it difficult to assess the impact of seasonal factors on our business. However, our business is dependent upon the home improvement industry. As a result, we expect that our revenues may be lower during the first and fourth quarters since more homeowners commit to home improvement projects during the spring and summer months. Being dependent on the home improvement industry exposes us to cyclical movements in the economy in general, especially as they relate to consumers willingness to make large expenditures that are mostly discretionary. Our limited operating history and the state of the economy for most of our existence make it difficult to assess the impact of cyclical factors on our business.

Our market is competitive and we may suffer price reductions, be unable to attract homeowners to our Web site, be unable to maintain our service provider network or enter into new multi-year commercial contracts if we do not compete effectively.

The market for our services is intensely competitive, evolving and subject to rapid technological change. To remain competitive, we must continue to enhance and improve the ease of use, responsiveness, functionality and features of our online and offline services in order to attract homeowners to our Web site and maintain our service provider network. We expect the intensity of competition to increase in the future. Increased competition may result in changes in our pricing model, fewer homeowners visiting our Web site, service providers leaving our network, less marketing revenue, reduced gross margins and loss of market share, any one of which could significantly reduce our future profitability. In addition, technological barriers to entry are relatively low. As a result, current competitors, including local referral businesses and online referral companies including ServiceMagic, HSS, and Homestore and potential competitors such as The Home Depot and Lowe's have launched Web sites similar to ours that could gain broader market acceptance based on content, products and services.

Some of our competitors have more resources and broader and deeper customer access than we do. In addition, many of these competitors have or can readily obtain extensive knowledge of the home improvement industry. Our competitors may be able to respond more quickly than we can to new technologies or changes in Internet user preferences and devote greater resources than we can to the development, promotion and sale of their services. We may not be able to maintain our competitive position against current and future competitors, especially those with significantly greater resources and brand recognition.

Homeowners and service providers may be reluctant to accept an Internet-based service provider matching service.

Currently most homeowners use traditional means including word-of-mouth referrals, Yellow Pages and local contractor matching services to obtain service providers for their home improvement projects. In addition, many service providers do not use the Internet for business purposes and may be reluctant to become part of a network of service providers on an Internet-based service provider matching service. If homeowners do not use our matching service or service providers do not join our network, we will not be able to generate significant revenues from either services or branding, or be able to enter into new multi-year commercial contracts.

If we do not attract and retain a network of high quality service providers, our business could be harmed.

We expect a significant portion of our revenues from our network of service providers in the form of payments for each homeowner referral that we provide to them and for each home improvement project that they win. Our business is highly dependent on homeowners' use of our Web site to find service providers for their home improvement projects so that service providers will achieve a satisfactory return on their participation in the ImproveNet program.

A key element of the growth of our business is the pace at which service providers adopt the ImproveNet matching process. This adoption includes responding to homeowner inquiries on a timely basis, providing a competitive, firm quote to homeowners quickly, and paying the service fees to ImproveNet. We devote significant effort and resources to screening and supporting participating service providers and to developing programs that monitor service providers' job wins and that collect service fees from service providers for these wins. Our inability to screen and support service providers effectively, or the failure of our service providers to respond professionally and in a timely manner to homeowner inquiries, could result in low homeowner satisfaction and harm our business. In addition, the failure of our service providers to win home improvement projects, report their wins to us, or pay us service fees could harm our business.

We must actively recruit new service providers and retain and motivate our current service providers to ensure that we continually have adequate coverage. We believe that service providers in the home improvement industry suffer from a relatively high failure or turnover rate which makes it difficult for us to retain service providers. Accordingly, we expect that not all of our service providers will remain active participants in our network. If we are unable to achieve low turnover among our network of service providers our business could be harmed.

If homeowners fail to report, and service providers fail to report and to pay to us win fees, directly or indirectly, our business would be harmed.

Our service providers are responsible for paying us a win fee for each job that they obtain from us. We ask service providers not to pass on the cost of the win fee to the homeowner. However, we do not currently provide any guarantee to the homeowner that our service providers have not raised their rates to cover the win fee nor do we audit or plan to audit our service providers to confirm that they have not raised their rates. Homeowners may believe that they are indirectly paying us our win fee through the higher rates of service providers and, therefore, choose to select service providers through word-of-mouth referrals, Yellow Pages, local contractor matching services or other means rather than using our matching service. If homeowners choose not to use our service, we will lose service revenues and visitors to our Web sites and our business will be harmed.

We depend on our service providers and homeowners to report that they have won a job and pay us our win fee. We rely on our relationship with our service providers and the incentive to receive future leads from us to encourage service providers to report wins and pay win fees. If service providers do not report wins or pay us win fees, we will lose service revenues and our business will be harmed.

We depend on third-party relationships to attract visitors to our Web sites.

We have entered into multi-year commercial contracts with suppliers of home improvement products and services to generate revenues and increase the number of visitors to our Web sites. Under these contracts, suppliers have placed links to our Web site from their Web sites to allow their customers to visit our Web site if the customers are interested in obtaining home improvement information or searching for a service provider. We believe that increasing the number of visitors to our Web sites will increase the number of job submissions. We cannot assure you that these contracts will lead to increased visits to our Web sites or that increased visits to our Web sites will result in increased job submissions. If we do not maintain our existing multi-year commercial contracts on terms as favorable as currently in effect or if we are not able to establish new contracts on commercially reasonable terms, our business could be harmed.

Companies that we may pursue for a multi-year commercial contract may offer services competitive with suppliers with which we currently have multi-year contracts. As a result, these suppliers may be reluctant to enter into multi-year commercial contracts with us.

We depend on third-party relationships to provide software tools and infrastructure.

We integrate third-party software into our service offerings on our Web sites. We would be harmed if the providers from which we license software ceased to deliver and support reliable products, to enhance their current products, or to respond to emerging industry standards. In addition, third-party software may not continue to be available to us on commercially reasonable terms or at all. The loss of, or inability to maintain or obtain, this software could limit the features available on our Web sites, which could harm our business.

If we fail to attract and retain qualified personnel, our ability to compete could be harmed.

We depend on the continued service of our key technical, sales and senior management personnel. In particular, the loss of the services of Ronald B. Cooper, our President and Chief Executive Officer, or other senior management personnel, individually or as a group, could cause us to incur increased operating expenses and divert other senior management time in searching for their replacements. We do not have employment agreements with any employee, except Mr. Cooper, and we do not maintain any key person life insurance policies for any of our key employees, except for Mr. Cooper. The loss of any of our key technical, sales or senior management personnel could harm our business.

In addition, we must attract, retain and motivate highly skilled employees. Given the fact that we had major restructurings during March and September 2001, we face significant challenges to retain individuals with the skills required to develop, market and support our services. We may not be able to recruit and retain sufficient numbers of highly skilled employees, and as a result our business could suffer.

If we fail to adequately protect our proprietary rights, we could lose these rights and our business could be harmed.

We depend upon our ability to develop and protect our intellectual property rights, including our databases of homeowners and service providers and our internally-developed matching criteria and algorithms, to distinguish our services from our competitors' services. We rely on a combination of copyright, trademark and trade secret laws, as well as confidentiality agreements and licensing arrangements, to establish and protect our proprietary rights. We have no issued patents. Our databases are protected by trade secret laws and our matching service is protected primarily by trade secret and copyright laws. Existing laws afford only limited protection of intellectual property rights. Attempts could be made to copy or reverse engineer aspects of our processes or services or to obtain and use information that we regard as proprietary. Accordingly, we may not be able to protect our intellectual property rights against unauthorized third-party copying or use. Furthermore, policing the unauthorized use of our intellectual property is difficult, and expensive litigation may be necessary in the future to enforce our intellectual property rights. The use by others of our proprietary rights could harm our business.

Our services could infringe the intellectual property rights of others causing costly litigation and the loss of significant rights.

Third parties could claim that we have infringed their intellectual property rights by claiming that our matching service infringes their patents, trade secrets or copyrights. In the ordinary course of business, we have received, and may receive in the future, notices from third parties claiming infringement of their proprietary rights. In addition, providers of goods and services over the Internet are increasingly subject to claims that they infringe patents that cover basic elements of electronic commerce. The resolution of any claims could be time-consuming, result in costly litigation, delay or prevent us from offering our services or require us to enter into royalty or licensing agreements, any of which could harm our business. In the event an infringement claim against us is successful and we cannot obtain a license on acceptable terms, license a substitute technology or redesign our services, our business would be harmed. Furthermore, former employers or our current and future employees may assert that our employees have improperly disclosed to us or are using confidential or proprietary information in our business.

If we experience system failures, our reputation would be harmed and users might seek alternative service providers, causing us to lose revenues.

We depend on the efficient and uninterrupted operation of our computer and communications hardware and software systems. Substantially all of our computer hardware for operating our Web sites is currently located at Qwest Communications in Sunnyvale, California, with backups located at our facility in Redwood City, California. These systems and operations are vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunication failures and similar events. They are also subject to break-ins, sabotage, intentional acts of vandalism and similar misconduct. We do not have fully redundant systems, a formal disaster recovery plan or alternative providers of hosting services, and we do not carry business interruption insurance to compensate us for losses that could occur. Despite any precautions we may take, the occurrence of a natural disaster or other unanticipated problems either at Qwest or at our facility could result in interruptions in our services. Any damage to or failure of our systems could result in interruptions in our service. In addition to placing an increased burden on our engineering staff, any system failure could create user questions and complaints that must be responded to by our customer support personnel. The system failures of various third-party Internet service providers, online service providers and other Web site operators could result in interruptions in our service to those users who require the services of these third-party providers and operators to access our Web sites. These interruptions could reduce our revenues and profits, and our future revenues and profits will be harmed if our users believe that our system is unreliable. Since we have been keeping logs of our Web sites, our ImproveNet.com Web site has been unintentionally interrupted for periods ranging from two minutes to one hour, the latter prior to February 2000. On one occasion, prior to February 2000, some users experienced interruptions in part of our service for a period of 48 hours.

We may have capacity restraints that could limit the growth of or reduce our revenues.

The satisfactory performance, reliability and availability of our Web sites, processing systems and network infrastructure are critical to our reputation and our ability to attract and retain large numbers of users. If the volume of traffic, including at peak times, on our Web sites increases, we will need to expand and upgrade our technology, transaction processing systems and network infrastructure. We may not be able to accurately project the rate or timing of these increases, if any, in the use of our services or to expand or upgrade our systems and infrastructure in a timely manner to accommodate these increases.

We use internally developed systems for operating our services and processing our transactions, including billing and collections processing. We must continually improve these systems in order to accommodate the level of use of our Web sites. In addition, if we add new features and functionality to our services, we could be required to develop or license additional technologies. Our inability to add additional software and hardware or upgrade our technology, transaction processing systems or network infrastructure could cause unanticipated system disruptions, slower response times, degradation in levels of customer support, impaired quality of the users' experience, delays in accounts receivable collection or losses of recorded financial information. Our failure to provide new features or functionality also could result in these consequences. The required hardware may not be readily available or affordable and we may be unable to effectively upgrade and/or expand our systems in a timely manner or to integrate smoothly any newly developed or purchased technologies with our existing systems. These difficulties could harm or limit our ability to expand our business.

We could be held liable for products and services referred by means of our Web site.

We could be subject to claims relating to products and services that we refer through our Web site. Homeowners may bring claims against us for referring service providers who may have, among other things, provided them with poor workmanship or caused bodily injury or damage to property. Our existing insurance coverage may not cover all potential claims, may not adequately cover all costs incurred in defense of potential claims, may not indemnify us for all liability that may be imposed or may not be renewable in future periods or renewable on terms and conditions satisfactory to us. In addition, claims, with or without merit, would result in diversion of our financial resources and management resources.

We could be held liable for general contracting services we perform.

We could be subject to claims related to general contractor services we provide to homeowners. Homeowners may bring claims against us for providing general contractor services that, among other things, result in poor workmanship or cause bodily injury or damage to property. Our existing insurance coverage may not cover all potential claims, may not adequately cover all costs incurred in defense of potential claims, may not indemnify us for all liability that may be imposed or may not be renewable in future periods or renewable on terms and conditions satisfactory to us. In addition, claims, with or without merit, would result in diversion of our financial resources and management resources.

We depend on the increasing use of the Internet. If the use of the Internet does not grow, our revenues may not grow and could decline and our business could be harmed.

We depend on increased acceptance and use of the Internet. In particular, our matching service depends upon service providers being willing to use the Internet to find jobs through our service. We believe that service providers generally have not traditionally used computers or the Internet to operate their businesses. Demand and market acceptance for recently introduced products and services over the Internet are subject to a high level of uncertainty. As a result, acceptance and use of the Internet may not develop or a sufficiently broad base of users may not adopt or continue to use the Internet as a medium of commerce.

The Internet is characterized by rapidly changing technologies, frequent new product and service introductions and evolving industry standards.

To succeed, we will need to adapt effectively to rapidly changing technologies and continually improve the performance features and reliability of our services. We could incur substantial costs in modifying our products, services or infrastructure to adapt to these changes, and we may also lose customers and revenues if our services fail to adapt to the rapid changes characteristic of the Internet.

Conversely, if the Internet experiences increased growth in number of users, frequency of use and bandwidth requirements, the Internet infrastructure may be unable to support the demands placed on it. The success of our business will rely on the Internet providing a convenient means of interaction and commerce. Our business depends on the ability of users to access information without significant delays or aggravation.

Future government regulations and legal uncertainties pertaining to the Internet could decrease the demand for our services or increase the cost of doing business.

There is, and will likely continue to be, an increasing number of laws and regulations pertaining to the Internet. These laws and regulations may relate to liability for information retrieved from or transmitted over the Internet, online content, user privacy, taxes or the quality of services. Any new law or regulation pertaining to the Internet, or the adverse application or interpretation of existing laws, could decrease the demand for our services or increase our cost of doing business.

We are not certain how our business may be affected by the application of existing laws governing issues such as property ownership, copyrights, encryption and other intellectual property issues, taxation, libel, obscenity and export or import matters. The vast majority of these laws was adopted prior to the advent of the Internet. As a result, they do not contemplate or address the unique issues created by the Internet and related technologies. Changes in laws intended to address these issues could create uncertainty for or adversely affect companies doing business on the Internet. This could reduce demand for our services or increase the cost of doing business.

Legislative and regulatory initiatives regarding the collection and use of our users' personal information may result in liability and expenses.

Current computing and Internet technology allows us to collect personal information about our users. In the past, the Federal Trade Commission has investigated companies that have sold personal information to third parties without permission or in violation of a stated privacy policy. Currently, we collect personal information only with the users' consent and under our privacy policy. If we begin collecting or selling personal information without permission or in violation of our privacy policy, we could face potential liability for compiling and providing information to third parties.

The imposition of additional state and local taxes on Internet-based transactions would increase our cost of doing business and harm our ability to become profitable.

We file state tax returns as required by law based on principles applicable to traditional businesses. However, one or more states could seek to impose additional income tax obligations or sales and use tax collection obligations on out-of-state companies such as ours that engage in or facilitate Internet-based commerce. A number of proposals have been made at state and local levels that could impose taxes on the sale of products and services through the Internet or the income derived from those sales. These proposals, if adopted, could substantially impair the growth of Internet-based commerce and harm our ability to become profitable.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash and cash equivalents in a variety of securities, including both government and corporate obligations and money market funds.

Our exposure to market risk for changes in interest rates relates primarily to increases or decreases in the amount of interest income we earn on our investment portfolio and on increases or decreases in the amount of interest expense we must pay with respect to any outstanding debt instruments. We mitigate default risk by investing in only high credit quality securities that we believe to be low risk and by positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer or guarantor.

We do not hold derivative financial instruments as of September 30, 2001, and have never held such instruments in the past. In addition, we had no debt instruments outstanding as of September 30, 2001. We currently transact all of our revenues, which are all traded in the United States in U.S. dollars.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may be involved in litigation relating to claims arising out of our operations. As of the date of this filing, we are not engaged in any material legal proceedings.

Item 2. Changes In Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

Due to regulatory requirements associated with being delisted, our repurchase program has been suspended.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit Number	Description of Document
10.36	Stock Repurchase Agreement

(b) A current report on Form 8-K was filed with the Securities and Exchange Commission on July 9, 2001, regarding ImproveNet's delisting from the Nasdaq National Market.

Signatures

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed, November 13, 2001 on its behalf by the undersigned duly authorized.

IMPROVENET, INC.

(Registrant)

By:/s/ Ronald Cooper

Ronald Cooper

Chairman, CEO & President

Date: November 13, 2001